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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 953

WILLIAM M. LIDDON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

MARIA PROTHRO LIDDON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 228a–239a) are reported at 22 T. C. 1220. The opinion of the Court of Appeals (Pet. 27–42) is reported at 230 F. 2d 304.

JURISDICTION

The judgments of the Court of Appeals were entered on February 11, 1956. (Pet. 26–27.) A peti-

tion for rehearing was denied on March 9, 1956. (Pet. 49.) The petition for a writ of certiorari was filed on May 18, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether, on the facts of this case, the Court of Appeals correctly affirmed the Tax Court's determination that accumulated earnings of a corporation were distributed to its controlling stockholders (taxpayers) pursuant to a plan of reorganization, and were taxable to those stockholders as dividends under Section 112 (c) (2) of the Internal Revenue Code of 1939 rather than as long-term capital gain under Section 115 (c).

STATUTE INVOLVED

The pertinent portions of Sections 112 and 115 of the Internal Revenue Code of 1939 are set forth in the Appendix, *infra,* pp. 14–18.

STATEMENT

The facts, as found by the Tax Court (R. 228a–233a) and the Court of Appeals (Pet. 27–37), are as follows:

During 1948, the taxable year involved, the taxpayers, husband and wife, together owned eighty per cent of Liddon Motors, Inc., a Tennessee corporation (hereinafter called the "old corporation") engaged in the business of selling and

servicing automobiles under a franchise dealer contract with the Pontiac Motor Division of the General Motors Corporation (hereinafter called "Pontiac"). The husband was president and the wife vice-president of the corporation. The remaining twenty per cent of the stock was owned by R. H. Davis, the general manager of the corporation. (Pet. 28.)

Among other things, the franchise agreement provided in paragraph "Third" that it had been entered into in reliance upon W. M. Liddon's and Davis' active and substantial participation in the ownership and operation of the dealership, and that the ownership, financial interests or active management of dealership should not be transferred. It was elsewhere provided that Pontiac could terminate the agreement immediately in the event that either Liddon or Davis ceased to participate in the business. (Pet. 28–29.)

In April, 1948, because of ill health, Davis tendered his resignation as general manager of the corporation, and also notified taxpayers that he wished to sell or liquidate his interest in the corporation as soon as possible. On April 27, 1948, Davis wrote to Pontiac, advising them that he had tendered his resignation to the old corporation; that he was liquidating his stock ownership; and that it was agreeable with him that, in any future contracts between Pontiac and the old corporation or its successor, he not be considered a

responsible participant under Paragraph Third of the contract. (Pet. 29.)

At special meetings of the stockholders and of the directors of the old corporation held on April 26, 1948, Davis offered his stock for sale to the other stockholders (taxpayers) at book value, but they did not accept. It was resolved at this meeting that the practical and equitable way to liquidate Davis' stock would be to liquidate and dissolve the old corporation. (Pet. 29.)

A few days later, on May 1, 1948, Liddon Pontiac, Inc. (hereinafter called the "new corporation") was incorporated by taxpayers under the laws of Tennessee. Its initial capital consisted of $5,000 contributed in cash by taxpayers, plus a $10 qualifying share held by a third party. Within three weeks taxpayers contributed an additional $20,000 to the capital of the new corporation. This total contribution of $25,000 was made from taxpayers' personal funds. (Pet. 29–30.)

On the day of its creation the new corporation was substituted for the old corporation in the franchise dealer agreement with Pontiac. This new agreement was essentially the same as the previous agreement between Pontiac and the old corporation, except that only the name of taxpayer W. M. Liddon was entered in Paragraph Third of the new agreement, instead of the names of both Liddon and Davis. Pontiac had cancelled the old agreement some time between April 27,

the date of Davis' letter, and May 1, the date of the agreement with the new corporation. (Pet. 30.)

On May 6, 1948, at a special meeting of its board of directors, the old corporation was directed to sell its operating assets to the new corporation at book value, to permit the new corporation to use the remaining physical assets without charge pending negotiation for their sale, and to transfer its employees' retirement fund to the new corporation. The new corporation accepted this arrangement. (Pet. 30.)

At another special meeting of its board of directors, held on July 4, 1948, the old corporation was authorized to pay Davis $11 per share for his stock, which was its approximate book value. On the same day the old corporation gave Davis its check for $22,000, and his shares were retired. At a subsequent meeting on July 13, 1948, the old corporation was authorized to distribute the balance of its assets to its two remaining stockholders, the taxpayers. These assets, consisting of more than $150,000 in cash and notes, were promptly paid over to taxpayers in equal shares. Four days later the old corporation surrendered its charter. (Pet. 30.)

The taxpayers each reported the amount received ($75,618.64) in exchange for shares in the old corporation, less the cost of the old corporation stock ($6,800), as a long-term capital gain for 1948. (Pet. 30.) The Commissioner deter-

mined that the gain was taxable as ordinary dividend income. In a decision reviewed by the full court the Tax Court unanimously sustained the Commissioner's determination. (Pet. 31.) The Court of Appeals (one judge dissenting) affirmed, except as to the $25,000 which taxpayers had invested in the new corporation before liquidating the old. As to this sum, the court held it was in substance an advance to the business which was repaid when the old corporation was liquidated. (Pet. 31–37.)

ARGUMENT

The decision below, affirming the Tax Court on the issue raised by the petition for a writ of certiorari, is clearly correct. The case turns on its own facts; there is no conflict, and no occasion for further review.

1. A corporation of which taxpayers were the controlling stockholders transferred its operating assets to a new corporation, also controlled by them, which carried on the same business as had its predecessor. The old corporation then redeemed the shares of the minority stockholder and distributed its remaining assets—representing undistributed earnings—to taxpayers in liquidation. Viewing the transaction as a whole from beginning to end, the Tax Court concluded that the liquidation of the old corporation was but a step in a plan of reorganization as defined in Section 112 (g) (1) (D) of the Internal Revenue

Code of 1939 (Appendix, *infra*, pp. 15–16), and that the liquidation distribution had the effect of the distribution of a taxable dividend under Section 112 (c) (1) and (2) (Appendix, *infra*, p. 15). The Court of Appeals agreed, rejecting taxpayers' contention that the liquidation of the old corporation was to be treated as a separate and isolated transaction resulting in capital gain under Section 115 (c) (Appendix, *infra*, p. 17). Its affirmance of the Tax Court's decision is in complete accord with the controlling statutory provisions and the applicable principles.

Under Section 112 (b) (3) (Appendix, *infra*, p. 14) no gain or loss is recognized if stock in a corporation is exchanged solely for stock in another corporation pursuant to a plan of reorganization.[1] However, Section 112 (c) (1) provides that if the property received in exchange consists not only of stock, but also of "other property or money" (commonly referred to as "boot"), then the gain to the recipient shall be recognized, but in an amount not exceeding the "boot." Section 112 (c) (2) provides that if a

[1] Section 112 (g) (1) (D) (Appendix, *infra*, pp. 15–16) defines a "reorganization" as including a "transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred." Under Section 112 (h) (Appendix, *infra*, pp. 16–17) "control" means ownership of at least eighty percent of the voting stock and of the total number of shares of all other classes of stock.

distribution pursuant to a plan of reorganization is within the provisions of Section 112 (c) (1), but "has the effect of the distribution of a taxable dividend," then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under Section 112 (c) (1) as is not in excess of his ratable share of the undistributed earnings of the corporation. A "dividend" is broadly defined in Section 115 (a) (Appendix, *infra,* p. 17) as any distribution by a corporation to its shareholders out of current or accumulated earnings; this definition is "infused" into Section 112 (c) (2), and, accordingly, "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of the distribution of a taxable dividend' within § 112 (c) (2)." *Commissioner* v. ***Estate of Bedford,*** 325 U. S. 283, 292. See also *Bazley* v. *Commissioner,* 331 U. S. 737, 743. The provisions of Section 115 (c), that amounts distributed in complete or partial liquidation of a corporation shall be treated as in full or partial payment in exchange for the stock, govern liquidation distributions "apart from reorganizations," and "do not apply to a situation arising within § 112." *Commissioner* v. *Estate of Bedford, supra,* p. 291. See also *Lewis* v. *Commissioner,* 176 F. 2d 646 (C. A. 1st); *Love* v. *Commissioner,* 113 F. 2d 236 (C. A. 3d); *Becher* v. *Commissioner,* 221 F. 2d 252 (C. A. 2d).

The Tax Court correctly held in this case that the entire transaction—the redemption of the

minority stockholder's shares, the formation of the new controlled corporation, the transfer of assets from the old to the new, and the liquidation of the old corporation after the new one took over the business—constituted a reorganization rather than a mere liquidation of the old corporation. The transaction falls precisely within the definition of a "reorganization" in Section 112 (g) (1) (D) and (h) (Appendix, *infra*, pp. 15–17), since the old corporation transferred its operating assets to the new and immediately thereafter the controlling stockholders of the old were in control of the new. *Lewis* v. *Commissioner, supra; Love* v. *Commissioner, supra;* cf. *Miller* v. *Commissioner,* 103 F. 2d 58 (C. A. 6th); *Fisher* v. *Commissioner,* 108 F. 2d 707 (C. A. 6th), certiorari denied, 310 U. S. 627; *Starr* v. *Commissioner,* 82 F. 2d 964 (C. A. 4th), certiorari denied, 298 U. S. 680. Under Section 112 (b) (3) no gain was recognizable on the exchange of stock in the old corporation for stock in the new. But in addition to the new stock each taxpayer received $75,618.64 in money and other property ("boot"), resulting in a reported gain of $68,818.64 each. (R. 233a.) Since the gain did not exceed the "boot," the entire gain was recognizable by virtue of the provisions of Section 112 (c) (1). *Miller* v. *Commissioner, supra; Starr* v. *Commissioner, supra.* And since the recognized gain did not exceed the undistributed earnings of the old corporation, it

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was also taxable as a dividend by virtue of the provisions of Section 112 (c) (2). *Commissioner* v. *Estate of Bedford, supra; Love* v. *Commissioner, supra; Lewis* v. *Commissioner, supra; Rose* v. *Little Inv. Co.*, 86 F. 2d 50 (C. A. 5th); *Commissioner* v. *Forhan R. Corp.*, 75 F. 2d 268 (C. A. 2d); *Commissioner* v. *Owens*, 69 F. 2d 597 (C. A. 5th); *Campbell* v. *United States*, 144 F. 2d 177, 181–182 (C. A. 3d). "It has been ruled in a series of cases that where the stock of one corporation was exchanged for the stock of another and cash and then distributed, such distributions out of earnings and profits had the effect of a distribution of a taxable dividend under § 112 (c) (2)." *Commissioner* v. *Estate of Bedford, supra*, p. 291.

2. Taxpayers assert a "conflict" with the prior decision of the court below in *United States* v. *Arcade Co.*, 203 F. 2d 230, certiorari denied, 346 U. S. 828, wherein the trial court's conclusion that a liquidation rather than a reorganization had occurred was affirmed on appeal. But, as the Court of Appeals said in likewise affirming the trial court's conclusion here, its earlier decision is distinguishable on its facts. (Pet. 33–34.)[2]

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[2] Chief Judge Simons, who participated in the decision in the *Arcade* case, also participated in the decision herein. It is noteworthy, too, that, although the dissenting opinion below was written by the same judge who wrote the *Arcade* opinion (Judge McAllister), it makes no mention of that case.

In *Arcade* the Court of Appeals affirmed the trial court's determination that a liquidation rather than a reorganization took place because (p. 233) the stockholders had become the "absolute owners" of the corporate assets before transferring them to a new corporation, resulting in a "break in the continuity of ownership." On the other hand, in the present case, as the same court points out (Pet. 33), "the statutory definition of a reorganization was precisely met." Here, the stockholders never became the intervening owners of the corporate assets, and hence there was no break in ownership. On the contrary, the old corporation transferred its operating assets directly to the new corporation, which continued the business without interruption. Moreover, in *Arcade* the court emphasized (pp. 232–233) that the old corporation had been liquidated and dissolved "before the new corporation received the assets." The present case presents the opposite situation, for here the old corporation was not liquidated or dissolved until after the new corporation was formed; indeed, the new corporation was formed for the very purpose of receiving the operating assets directly from the old. *Braicks* v. *Henricksen*, 43 F. Supp. 254 (W. D. Wash.), affirmed, 137 F. 2d 632 (C. A. 9th), also relied upon by taxpayers (Pet. 10), involved facts almost identical to those of *Arcade*, and was similarly distinguished by the court below (Pet. 33).

As for *Mascot Stove Co.* v. *Commissioner*, 120

F. 2d 153, 156 (C. A. 6th), certiorari denied, 315 U. S. 802, while the court there stated that "liquidation is the antithesis of reorganization," this quotation, as the same court points out (Pet. 34), is plainly inapposite here when read in its context (cf. Pet. 11). The quotation was addressed to a bankruptcy liquidation, and (Pet. 34) "what the court there decided was that, since the old corporation was adjudicated a bankrupt, its shareholders had nothing to transfer." Unlike that case the instant one involves a transfer of assets by a solvent corporation in which the stockholders did have an equity, and the continuity of interest requirement of Section 112 is satisfied.[3] The fact is, as the court below also makes clear (Pet. 35–36), that there is nothing inconsistent between a liquidation and a reorganization. Indeed, termination of the transferor corporation's existence is a natural and frequent concomitant of a statutory reorganization, and often is one of the steps in a plan of reorganization. *Commissioner* v. *Whitaker*, 101 F. 2d 640 (C. A. 1st); *Lewis* v. *Commissioner, supra*, p. 649; *Helvering* v. *Schoellkopf*, 100 F. 2d 415 (C. A. 2d); *Love* v. *Commissioner, supra*, p. 238; *Fisher* v. *Commissioner, supra*, p. 709.

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[3] For the same reasons, *Glenn* v. *Courier-Journal Job Printing Co.*, 127 F. 2d 820 (C. A. 6th) (see Pet. 11), is also to be distinguished from the present case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JUNE 1956.

APPENDIX

Internal Revenue Code of 1939:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(3) *Stock for stock on reorganization.*—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(4) *Same.—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more per-

sons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(c) [As amended by Section 121 (d) (1) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gain From Exchanges Not Solely in Kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5), or within the provisions of subsection (1), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

* * * * *

(g) [As amended by Section 213 (b) of the Revenue Act of 1939, c. 247, 53 Stat.

862, and Section 121 (d) (4) of the Revenue Act of 1943, *supra*] *Definition of Reorganization.*—As used in this section (other than subsection (b) (10) and subsection (1)) and in section 113 (other than subsection (a) (22))—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

(h) *Definition of Control.*—As used in this section the term "control" means the

ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

* * * * *

(26 U. S. C. 1952 ed., Sec. 112.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(c) [As amended by Section 147 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. * * *

* * * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * * *

(i) *Definition of Partial Liquidation.*—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * * *

(26 U. S. C. 1952 ed., Sec. 115.)

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IN THE

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OCTOBER TERM, 1955.

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit.

REPLY OR SUPPLEMENTAL BRIEF ON BEHALF OF PETITIONERS.

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